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Treatment of Prepayment Prohibitions in Bankruptcy Is Proving to be a Tough Call for Courts

Restrictions on a borrower's ability to prepay secured debt obligations are a common feature of modern bond indentures and credit agreements. Lenders frequently employ "no-call" provisions to prevent borrowers from refinancing or retiring outstanding debt prior to maturity. Loan documents also may permit prepayment at the borrower's option, but conditioned on the payment of a "makewhole premium" (often referred to as a "prepayment penalty"). Makewhole premiums, which are often expressed as a percentage of the outstanding principal balance, are designed to compensate the lender for the loss of the remaining stream of interest payments it would have received had the borrower continued to service the debt through the maturity date of the loan. Loan documents generally do not provide for the payment of a makewhole premium during a no-call period, because no-call provisions are flat prohibitions on prepayment and are generally enforced outside of bankruptcy.

When a borrower files for bankruptcy and desires to repay its debt despite the existence of a no-call provision, there is a tension between the rehabilitative policies and equitable principles underlying chapter 11, on the one hand, and the rights and expectations of lenders, on the other hand. Because chapter 11 is designed to permit companies to shed burdensome debt obligations and undergo a comprehensive restructuring of their balance sheets, bankruptcy courts uniformly refuse to enforce no-call provisions against debtors and routinely permit the repayment of outstanding debt. In chapter 11 cases, lenders have a difficult time arguing for the payment of a makewhole premium for a breach of a no-call provision because those premiums generally are not due under the applicable loan documents during the no-call period. As a result, lenders alternatively argue that they nevertheless are entitled to contract damage claims — independent of a makewhole premium — for their "dashed expectations" when their outstanding debt has been paid prior to its original maturity. Debtors have objected to these "dashed expectations" claims, arguing that there is no basis for such claims in the applicable loan documents. Three very recent decisions highlight how courts are addressing these disputes.

In re Calpine Corporation[1]

During its chapter 11 cases, Calpine Corporation ("Calpine") sought to refinance its debtor-in-possession financing, among other reasons, to repay approximately $2.5 billion of prepetition secured project level debt of a debtor affiliate, CalGen. The three tranches of the CalGen project debt contained no-call provisions barring CalGen's optional repayment during certain time periods. For the senior two tranches, the debt could be repaid at CalGen's option after certain dates, but subject to a makewhole premium. The third tranche could not be repaid at all before maturity. Calpine sought to repay all three tranches of CalGen debt during the no-call periods (and before any makewhole premiums were due for the senior two tranches). The lenders objected to the repayment, arguing that the credit documents precluded Calpine from repaying the secured debt during the no-call period, or alternatively, that the lenders were entitled to "dashed expectations" (i.e., breach of contract) claims for the lost future interest income for which they had bargained.

The bankruptcy court determined at the outset of its decision that Calpine could repay CalGen's prepetition debt notwithstanding the no-call provisions in the loan documents, recognizing that such provisions "are unenforceable in chapter 11 cases." The bankruptcy court next considered whether the lenders nonetheless were entitled to a secured claim for their "makewhole" damages. The bankruptcy court noted that section 506(b) of the Bankruptcy Code allows oversecured creditors to recover postpetition interest on their claims, as well as "any reasonable fees, costs, or charges provided for under the [applicable] agreement."[2] The bankruptcy court then analyzed whether the applicable loan documents provided for payment of a makewhole claim in this particular context. The bankruptcy court found that under the loan documents, CalGen's bankruptcy filing automatically accelerated the maturity date of the CalGen debt, rendering it "due and payable immediately." Further, although the loan documents prohibited optional repayment prior to certain dates (depending on the tranche), there was no corresponding requirement to pay a makewhole premium in the event of repayment prior to those dates, but after the automatic acceleration of the debt. Thus, the bankruptcy court held that because the loan agreements never specifically required the payment of any "charges" for makewhole damages resulting from the repayment of the CalGen debt upon maturity in the event of acceleration, the lenders were not entitled to add secured makewhole damages to their allowed secured claims under section 506(b) of the Bankruptcy Code.

However, the bankruptcy court went on to hold that the CalGen lenders were entitled to *unsecured* claims arising from the repayment because their "expectation of an uninterrupted payment stream has been dashed giving rise to damages." In calculating the lenders' "dashed expectations" damages, the bankruptcy court found that the 2.5% makewhole premium for the first lien CalGen debt and the 3.5% makewhole premium for the second lien CalGen debt, respectively, were "reasonable proxies for measures of damages to be awarded to those creditors." Although the third tranche of CalGen debt prohibited repayment during the entire life of the loan and thus lacked any makewhole provision in the event of repayment prior to maturity, the bankruptcy court found that the 3.5% premium for the second lien CalGen debt was a reasonably proxy for the third lien CalGen lenders' damages.

The CalGen lenders, Calpine and the official committee of unsecured creditors appealed the bankruptcy court's decision to the United States District Court for the Southern District of New York. Among other things, the CalGen lenders challenged the bankruptcy court's refusal to award them with secured makewhole claims under section 506(b), as well as the bankruptcy court's calculation of their damages. Calpine challenged the bankruptcy court's allowance of the unsecured "dashed expectation" claims.[3]

While the appeal of the *Calpine* opinion was pending, another bankruptcy court in the Southern District of New York took a different view. In Solutia Inc.'s chapter 11 cases, the court rejected bondholders' claims for dashed expectation damages arising from the debtors' repayment of obligations under a bond indenture prior to the stated maturity date. Specifically, the court noted that the indenture at issue provided that all outstanding obligations thereunder automatically accelerated upon the debtors' commencement of bankruptcy cases and stated as follows:

> "This Court respectfully disagrees with *Calpine* because it reads into agreements between sophisticated parties provisions that are not there . . . Nothing in the Bankruptcy Code requires this court to provide the 2009 Noteholders with more than the Original Indenture provides. Put yet another way, they have no dashed expectations for which compensation is due."[4]

When the district court ultimately considered the appeal of the *Calpine* opinion, the court agreed with the bankruptcy court that CalGen's lenders were not entitled to section 506(b) secured makewhole claims. The district court highlighted the fact that the CalGen debt documents "could have provided for the payment of premiums in the event of payment pursuant to acceleration," but they did not. The district court also held, however, that the lenders were not entitled to an *unsecured* claim either. The district court noted that no-call provisions are unenforceable in bankruptcy cases whether through specific performance (*i.e.*, enjoining chapter 11 debtors from satisfying debt obligations during a no-call period) or through a claim for actual or expectation damages. Then the court held that any claim for damages for breach of a no-call provision is precluded by the prohibition on claims for unmatured interest in section 502(b)(2) of the Bankruptcy Code because the automatic acceleration of the debt upon bankruptcy rendered any future interest obligations that would have otherwise accrued on the CalGen debt to be unearned as of the petition date (which was the same date on which the CalGen debt became accelerated and due and payable immediately).

In re Premier Entertainment Biloxi LLC (d/b/a Hard Rock Hotel & Casino Biloxi)[5]

Less than two weeks before the issuance of the district court's decision in *Calpine*, the Bankruptcy Court for the Southern District of Mississippi confronted the same issue in the chapter 11 case of the owners/operators of the Hard Rock Hotel & Casino in Biloxi. First lien mortgage lenders asserted claims for damages for the debtors' breach of a no-call provision, based on the debtors' repayment of the debt through the consummation of their chapter 11 plan in August 2007. The no-call provision at issue prohibited repayment of the debt at the issuers' option prior to February 1, 2008; thereafter, the indenture permitted the debtors to repay the debt prior to the 2012 maturity at a premium, but the premium decreased each successive year until it reached zero in 2010, two years before the 2012 maturity date. The mortgage indenture also provided that upon certain events of default, which included the commencement of a chapter 11 case, the debt automatically accelerated.

Like both the bankruptcy court and district court in *Calpine*, the Mississippi bankruptcy court determined that the lenders were not entitled to a secured claim for damages because the indenture only required the debtors to pay prepayment penalties if they paid the loan prior to maturity, which was not the case here as a result of the automatic acceleration of maturity upon the debtors' chapter 11 filing. As the Mississippi bankruptcy court held:

> Just like the noteholders in *Solutia*, by investing under the Indenture, which included an automatic acceleration provision, the Claimants gave up their expectation to a payment stream in the future. The Claimants chose to forego any prepayment premium in favor of an immediate right to collect their entire debt after a bankruptcy event of default. The parties to the Indenture are sophisticated investors who bargained for the risks and benefits of this undertaking of considerable size. Simply put, the Indenture itself did not provide the Claimants a premium or liquidated damages in the event of a bankruptcy default.

However, the Mississippi bankruptcy court followed the bankruptcy court's *Calpine* decision by awarding the lenders an unsecured claim for breach of contract damages, holding that "the non-breaching party is not deprived of a monetary remedy just because no-call provisions are not subject to the remedy of specific performance in bankruptcy cases." Additionally, the Mississippi bankruptcy court noted that where, as in *Premier Entertainment*, the debtors are solvent on a balance sheet basis, the role of the bankruptcy courts is to enforce creditors' prepetition rights. Ultimately, the bankruptcy court awarded the lenders their "actual damages" based on the difference, at the time the debt was repaid, between the present value of the expected interest payments at the contract rate and the market rate, plus interest at the federal judgment rate from the repayment date.

In re Chemtura Corporation[6]

Just recently, the enforceability of no-call provisions and makewhole penalties in chapter 11 once again was the subject of litigation in Chemtura Corporation's chapter 11 cases. In *Chemtura*, the debtors sought approval from the bankruptcy court of a global settlement among the debtors, the unsecured creditors' committee, and an ad hoc group of bondholders in connection with the confirmation of Chemtura's chapter 11 plan, over the objections of an equity committee. The settlement provided, among other things, for the debtors' prepayment of certain notes due in 2016 and 2026, plus a makewhole settlement payment (in the case of the 2016 notes) and a damages settlement payment for the debtors' alleged breach of a "no-call" provision (in the case of the 2026 notes). Although the legal standard employed by the bankruptcy court to approve the settlement did not require the court to decide the merits of whether no-call and makewhole provisions are enforceable in bankruptcy, the court still analyzed the various authorities on these topics in detail before approving the settlement and confirming Chemtura's plan of reorganization.

The *Chemtura* court determined that to resolve the potential litigation over the makewhole and no-call claims, a court would have to perform two analyses. First, a court would have to review the language of the governing credit agreements to determine whether state contract law would support such a claim, and then determine the appropriate damages calculation. The *Chemtura* court concluded that the makewhole claimants appeared to have a stronger litigation position than the debtors based on the language in the indenture, but that "the [no-call claimants] might have *Solutia* problems — inadequate drafting to give them the state law rights they wish to enforce — and it would be the [debtor] who'd have the stronger argument." Second, a court would have to analyze whether the claimants' state law claims are enforceable in bankruptcy by considering: (i) whether a bankruptcy court can allow claims for damages for a debtor's breach of a contractual provision that cannot be specifically performed in bankruptcy; (ii) whether makewhole premiums and damages for breach of no-call provisions "are proxies for unmatured interest," which are expressly disallowed in bankruptcy; and (iii) whether the chapter 11 debtor's solvency should determine whether damages claims for breach of a no-call provision are allowed. Upon analyzing these factors in depth, and the strengths and weaknesses of the parties' positions, the *Chemtura* court decided that the settlement was reasonable, even "[t]aking into account the new thinking in the area, as articulated [by the district court in *Calpine*] and *Premier Entertainment*."

Conclusion

The *Calpine, Solutia, Premier Entertainment,* and *Chemtura* decisions illustrate how bankruptcy courts are addressing no-call provisions, the enforcement of makewhole claims, and related issues, such as the propriety of unsecured "dashed expectations" claims. It likely will be up to the appellate courts to provide further guidance. With that in mind, creditors and debtors should take care to review the specific terms of the relevant loan documents to determine the circumstances under which debt can or cannot be repaid, in or outside of a chapter 11 case, as well as the potential costs that may be incurred as a result of such repayment.[7]

1 *In re Calpine Corp.,* 365 B.R. 392 (Bankr. S.D.N.Y. 2007), *aff'd sub nom. HSBC Bank USA, Nat'l Ass'n v. Calpine Corp.,* No. 07-civ-3088 (GBD), 2010 WL 3835200 (S.D.N.Y. Sept. 15, 2010).

2 11 U.S.C. § 506(b).

3 During the pendency of the *Calpine* appeal in the district court, Calpine settled with the CalGen first and second lien lenders.

4 *In re Solutia, Inc.*, 379 B.R. 473, 484 n.7 (Bankr. S.D.N.Y. 2007).

5 *Premier Entertainment Biloxi LLC v. U.S. Bank Nat'l Ass'n (In re Premier Entertainment Biloxi LLC),* No. 06-50975-NPO, Adv. No. 07-05043-NPO, 2010 WL 3504105 (Bankr. S.D. Miss. Sept. 3, 2010).

6 Bench Decision on Confirmation, *In re Chemtura Corp.*, No. 09-11233 (REG) (Bankr. S.D.N.Y. Oct. 21, 2010).

7 Kirkland & Ellis LLP has been lead debtors' counsel in the *Calpine*, *Solutia,* and *Chemtura* chapter 11 cases.

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